Feasibility of Social Security Individual Accounts

by

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The Public Policy Institute, formed in 1985, is part of Policy and Strategy at AARP. One of the missions of the Institute is to foster research and analysis on public policy issues of interest to older Americans. This paper represents part of that effort.

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Foreword

Concerns about the long-term solvency of Social Security have produced numerous options for Social Security reform, among them individual accounts that would allow individuals to manage their own retirement savings. Proponents of individual accounts have given a great deal of thought to the design of individual account structures, by addressing such issues as the degree to which the current system should be privatized, the appropriate rate of contributions to accounts, investment options, and withdrawal options. The administrative feasibility of individual accounts often receives less consideration.

Frequently, individual account proposals have consigned administration to a format that resembles the Thrift Savings Plan for Federal employees (TSP), without much further discussion. The TSP is a successful voluntary defined contribution plan. It was designed as the individual savings tier of a 3-tiered approach to retirement income security that includes Social Security as tier 1 and a defined benefit plan as tier 2. While the TSP is the largest defined contribution plan in the country, with 2.9 million participants and approximately $100 billion in assets, it pales in size to the over 144 million workers who would be potential participants of Social Security Individual Accounts (SSIAs). How would a TSP administrative structure manage 144 million individual accounts?

The administrative implications of establishing SSIAs are enormous for employers, workers, the government, and the various financial service entities that would potentially be a part of this program. This paper, “Feasibility of Social Security Individual Accounts,” was commissioned by AARP’s Public Policy Institute to analyze the feasibility of establishing and running a universal system of individual accounts modeled after the TSP. Francis Cavanaugh, as one of the TSP designers and its former Executive Director, is particularly well qualified to write this analysis.

The central argument of the paper is that a system of individual accounts cannot easily be adapted to the TSP format. Neither would it be a low-cost option. Mr. Cavanaugh outlines the reasons: there would be too many low-income employees and too many very small businesses for SSIAs to be cost-effective; small businesses generally do not have the financial resources or the personnel, payroll, or systems staffs to do what 401(k) employers now do; the typical proposed annual SSIA contribution of 2 percent of pay would be so small that much of it would be eaten away by administrative expenses; and finally, the prospects for future cost reductions are marginal.

These findings raise important issues for the discussion of Social Security reform and SSIAs. In particular, Mr. Cavanaugh casts doubt on the viability of using the TSP as a model for individual accounts. At the very least, this paper underscores the importance of examining with great care the administrative structure and costs of the various proposals for individual accounts.

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Executive Summary

In its December 2001 report, the President’s Commission to Strengthen Social Security proposed Social Security individual accounts (SSIAs), modeled in part on 401(k)-type plans like the Thrift Savings Plan (TSP) for federal employees. This Issue Paper argues that such proposals are not feasible. It focuses on the impact of administrative expenses on SSIA balances, the capability of small businesses to perform the functions normally performed by 401(k) employers, and the efficiency of SSIAs compared to similar investments in the Social Security trust fund.

There would be too many low-income employees and too many very small businesses for SSIAs to be cost-effective. More than 85 percent of businesses with fewer than 100 employees have no retirement plans. Small businesses generally do not have the financial resources or the personnel, payroll, or systems staffs to do what 401(k) employers now do. They could not be expected to assume the expenses or fiduciary responsibilities of 401(k) employers.

The Commission’s proposed annual contribution of 2 percent of pay (in its “basic” plan) to the average SSIA would be so small that more than 60 percent of the contribution would be required just to cover administrative expenses. Current average annual pay subject to Social Security taxes is about $26,000, so 2 percent would be about $520. Per capita administrative expenses would average more than $300 a year, and even more for employees of very small companies, based on current market costs. The potential cost of more than $46 billion a year (155 million workers x more than $300 per account) would be a subsidy to the 401(k) industry for performing an uneconomic function.

The prospects for future cost reductions are not good. The major 401(k) providers have been competing aggressively for many years to supply 401(k) plans to small businesses. They have achieved substantial economies of scale with state-of-the-art technology, but they still charge more than $3,000 a year for the average small business, which has fewer than ten employees. Thus major providers recommend against 401(k)s for businesses with fewer than ten employees, and some recommend against them for businesses with fewer than 20 or 25 employees. The Commission’s proposal to create a new federal agency would add to total costs. Moreover, the error rates that are now tolerated by IRS and SSA would be totally unacceptable in a 401(k) environment of day-to-day investment transactions.

Social Security and 401(k)s are based on entirely different criteria. Social Security is mandatory – it is a tax; 401(k)s are voluntary, for both the employer and the employee. Social Security is an insurance program; 401(k)s are investment programs. Social Security depends on the government to absorb inflation and market risks; 401(k)s shift those risks to individual investors. Social Security is a defined benefit program; 401(k)s are defined contribution programs. Social Security is a safety net for lower-income people; 401(k)s are a major tax
subsidy for higher-income people. Social Security is sponsored and administered by the government; 401(k)s are sponsored and administered by employers. As a result, issues that are not a problem for the 401(k) system -- such as the size of contributions, administrative expenses, and feasibility for small businesses -- would cause serious problems for Social Security.
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This Issue Paper analyzes the administrative feasibility of establishing a universal system of Social Security individual accounts (SSIA) modeled on 401(k)-type plans like the Thrift Savings Plan (TSP) for federal employees. The analysis focuses on the likely size of contributions to SSIA, the impact of administrative expenses on SSIA balances, the capability of small businesses to perform the functions normally performed by 401(k) employers, and the efficiency of SSIA compared to similar investments in the Social Security trust fund.

The TSP is a defined contribution retirement savings plan established by Congress in 1986 for employees in all three branches of the federal government, including members of Congress and federal judges. It is the largest defined contribution plan in the country, with 2.9 million participants and approximately $100 billion in assets. It is administered by the Federal Retirement Thrift Investment Board. The board is an independent federal agency governed by five part-time board members appointed for fixed terms by the President, with the advice and consent of the Senate, and a full-time executive director who is appointed by the board members and serves as chief executive officer of the board.

Like private 401(k) plans, the TSP is a tax-deferred, employer-sponsored, voluntary savings plan with matching contributions, and it relies on outside contractors and employers to provide most services. Currently, the TSP reimburses the U.S. Department of Agriculture’s National Finance Center (NFC) for providing record-keeping services for the TSP, such as maintaining the accounts of TSP participants, processing withdrawals, loans, and interfund transfers. The government agencies that employ TSP participants provide substantial non-reimbursed administrative support. The TSP depends on the federal employing agencies and their personnel, payroll and systems staff to handle operations such as the distribution of TSP forms and materials, employee education programs, and counseling. Employing agencies also transmit to the TSP every payday the amount of each employee’s (and the government’s) contributions, as well as investment choices, interfund transfers, loans, loan repayments, withdrawals, and other essential information. Thus, the TSP is essentially a wholesaler of services, and the employing agencies are the retailers who provide face-to-face contact.

Apart from the management structure, therefore, there is very little difference between the TSP and a 401(k) for a large corporation. SSIA, however, are intended to reach smaller businesses. Thus, to provide a guide as to the feasibility of modeling SSIA on the TSP, the experience of the 401(k) industry in attempting to provide services to small businesses must be examined.

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In recent years several bills have been introduced in Congress to establish SSIAs modeled on the TSP, including S. 21 in 1999 by then-Senator Daniel Moynihan. Senator Moynihan was appointed by President Bush in May 2001 as co-chair of the President’s Commission to Strengthen Social Security (CSSS). The President instructed the CSSS to recommend a system of voluntary individual investment accounts to augment the Social Security system. In its December 2001 final report, the CSSS presented three individual account options, all of which were modeled on the TSP/401(k) centrally financed structure rather than the Individual Retirement Account (IRA) structure. Although the three options differed in many important respects, for the purposes of this Issue Paper the only significant differences were in the percentages of taxable pay permitted to be contributed to the SSIAs, which ranged from two to four percent.

ASSUMPTIONS

It is assumed here that SSIAs would include the following major elements, which are common features in the CSSS and other major proposals. SSIAs would be:

- Available to all workers subject to Social Security taxes;
- Voluntary for employees. (The SSIAs would thus be mandatory for employers of employees who elect to participate and are entitled to certain employer benefits or services);
- Funded by deposits from employer and/or employee contributions of two percent of wages subject to Social Security taxes; and
- Modeled on 401(k) plans and the TSP, rather than on IRAs.

ADMINISTRATIVE EXPENSES

There is no precedent, either in the TSP or in 401(k)s, for SSIAs for the typical or average small business (defined as having 10 or fewer employees) in the United States. About 4 million of this country’s 6.5 million employers have small businesses under this definition. According to a TowerGroup report, “85 percent of companies with fewer than 100 employees do not have any sort of pension plan.” Thus, 401(k) plans are virtually nonexistent for the average company.

This is unknown territory. The average business is so small that it is outside the scope of the 401(k) industry. The proposal to model SSIAs on the TSP is a proposal to broaden that

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scope. The infeasibility of that proposal is evident from the failed experience of the 401(k) industry in its efforts to provide central financing and administration for average small businesses, i.e., businesses with fewer than 10 employees.\(^4\)

Average per capita SSIA administrative expenses would be prohibitively high, because the average private employer has too few employees to absorb the fixed costs of establishing and maintaining a plan. Annual 401(k) expenses average more than $3,000 for a plan with just 10 employees, or $300 per capita, based on current charges by major providers such as CitiStreet (a recent joint venture of Citibank and State Street Corporation) and Fidelity Investments, as discussed below. Also, a major study by the Department of Labor in 1998 showed that average per capita administrative expenses were close to $300 even for plans with 100 employees, and per capita administrative expenses were well over $300 for plans with just 10 employees.\(^5\) Other government and private-sector studies show that annual per capita administrative costs for defined contribution plan accounts average about $100, and could range up to more than $300 a person for plans with just 10 to 15 employees.\(^6,7\) Accordingly, per capita expenses for a plan with 5 employees could be more than $600, when the $3,000 fixed charges are averaged over fewer employees, which would be greater than the average annual per capita SSIA contribution of $520.\(^8\)

Therefore, it would not be cost effective for the government or the employer to pay the expenses of the average SSIA, since there are other options that would provide larger benefits to employees at lower costs. The potential annual cost could exceed $46 billion (155 million full-...
and part-time workers\(^9\) times an average of more than $300 per account), given that the majority of accounts are generated by small business.\(^10\) Thus, investment in private securities by the Social Security trust fund (at no appreciable administrative expense), rather than by SSIA, would result in potential net annual savings of more than $46 billion.

If the expenses were to be borne by the workers, it would be a breach of fiduciary responsibility to advise employees to contribute to plans that would yield such negative returns. Accordingly, a search of websites finds that major providers recommend against 401(k)s for companies with fewer than 10 employees.

For example, CitiStreet, in presenting its fully electronic “Success 401(k)” services for small businesses, suggests that for companies with fewer than 10 employees, CitiStreet’s plan “is not a good fit for your company.” CitiStreet’s website suggests that such companies consider a SIMPLE IRA instead.\(^{11,12}\)

Similarly, the largest 401(k) provider, Fidelity Investments, reports that “a 401(k) is generally most appropriate for companies with more than 25 employees.”\(^13\) T. Rowe Price says that its “401(k) Century plans are generally geared for businesses with more than $1 million in qualified plan assets,”\(^14\) which for a firm with ten employees implies an average account balance of $100,000. Merrill Lynch “has the ability to support 401(k) plans with over $3 million in plan

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\(^10\) Administrative costs of SSIA would, of course, be lower than $46 billion to the extent that low-income employees and small businesses were discouraged from establishing SSIA.


\(^12\) By contrast, State Street Corporation, which is one-half of the CitiStreet joint venture (the other half being Citibank), concluded that an individual account system modeled on the TSP would have administrative costs of $473 to $922 million in the first year of operation (or $3.38 to $6.58 per account). State Street Corporation is a major 401(k) provider and appears to have a conflict of interest on this issue. State Street’s estimate did not include the costs of collecting and reconciling earnings histories, transmitting earnings histories to the individual account recordkeeper, maintaining up to date employee address files, or communicating the program to employees—the estimate assumes the government (SSA) would bear these costs (page 13). The State Street study also assumed that the new system would realize economies of scale, would rely heavily on voice response technology, and that there would be no compliance testing (pages 14-15)—all three of these assumptions will be questioned in subsequent sections of this paper. Further, State Street’s cost model also assumes a very low level of services to participants: participants make only 0.5 to 1 calls per year, are allowed to invest in only one fund, make one fund transfer per year, receive one annual account statement, and are prohibited from taking out loans (page 12). See “Administrative Challenges Confronting Social Security Reform,” State Street Corporation, Boston, MA, March 22, 1999.


\(^14\) [http://www.troweprice.com/smallbusiness/index/0,2247,lang%253DENG%2526pgid%253D8286,00.html](http://www.troweprice.com/smallbusiness/index/0,2247,lang%253DENG%2526pgid%253D8286,00.html). Accessed on September 10, 2002.
assets.”15 The 401(k) industry’s second-largest player, Vanguard, reportedly “isn’t much interested in plans with fewer than 500 employees,”16 according to an article in Institutional Investor.

These statements indicate that today’s market will not support universal SSIA. The industry has learned that SSIA cannot be provided efficiently for most businesses in the United States. Thus, the future feasibility of SSIA depends on the prospects for substantial reductions in administrative expenses.

PROSPECTS FOR REDUCED EXPENSES

Increased Competition

It is unlikely that the potential for new business generated from federal government sponsorship of SSIA would stimulate competing 401(k) providers to offer less expensive options. Major providers have been aggressively seeking ways to serve small business customers, and have been around for 20 years.17 There appears to be little opportunity for further significant cost reduction. The current average per capita administrative expense of $300 cited above for companies with 10 employees is roughly the same as it was 4 years ago. The Wall Street Journal did a survey of administrative costs of 401(k)s for small businesses in 1998 and found the charges by major providers to be very competitive. The expenses averaged roughly $300 per capita for companies with 10 employees. The survey cited a typical example of a 401(k) set up by T. Rowe Price for a company with 10 employees and found a one-time start-up fee of $1,300, an annual administrative fee of $2,400 plus $35 per person, and an undisclosed investment management fee. These expenses clearly brought total annual costs to well over $3,000, or $300 per capita.18 Moreover, it now appears that even the most aggressive providers do not wish to service the “smallest small,” i.e., companies with fewer than 10 employees—which includes nearly two-thirds of Social Security covered employers.

Economies of Scale

There is a mistaken notion on the part of SSIA proponents that major economies of scale could be achieved by government “centralization” of SSIA administration in the Social Security


17 See section entitled “Administrative Expenses,” in which professional plan administrators are quoted about the appropriateness of 401(k)s for employers with fewer than 25 employees.

Administration (SSA) or in a new agency structured like the TSP or the Federal Reserve Board. (This notion may gain standing from the fact that the TSP system’s own administrative costs are very low.) The distinction between government centralization of SSIAAs and the centralization now offered to small businesses by 401(k) providers is a distinction without a difference. A new federal agency to administer SSIAAs would surely depend on employers and on outside investment and record-keeping contractors, as is the case with TSP and 401(k)s. The apparent attraction of government involvement in SSIAAs would be to shift costs (including hidden costs) and potential liabilities from the 401(k) industry to the government.

There is no reason to assume that a federal agency would be more efficient than the major private providers who have been aggressively seeking ways to offer 401(k) accounts to small businesses, and are already offering state-of-the-art central financing and administrative services. The major 401(k) providers discussed above have already achieved substantial economies by consolidating and computerizing record keeping, communication, investment, and other services that they furnish to many business plans.

The ability of 401(k) providers to achieve additional economies of scale would be sharply limited by the addition of millions of small business 401(k)s to the investment market. Small businesses and their employees would require expensive, professional, labor-intensive services to meet the education, counseling, investment, and record keeping needs of each business, as discussed below. Proposed 401(k) plans need to be presented in the context of the existing retirement, profit sharing, and other benefit programs of each business, and some services must be provided on site. Only if small businesses merged into larger businesses (with greater personnel, payroll, and systems resources) would significant further economies of scale seem possible.

The average SSIA would be much smaller than the average TSP account. Average SSIA annual per capita contributions would be about $520, which is 2 percent of the approximately $26,000 average wage subject to Social Security taxes in 2000. The reported Social Security taxable median income of all workers was actually lower than $19,000 in 1998. The current annual per capita TSP contribution averages about $4,200 (approximately $10 billion in annual contributions from 2.4 million active accounts). Average TSP account balances are about $34,000 ($100 billion in assets in 2.9 million total accounts).

Moreover, it would be impossible to realize economies of scale in certain areas of 401(k) provision. For example, the TSP service office maintains about 200 telephone counselors (in addition to its automated voice response system) to respond to participant inquiries. Since the number of eligible SSIAAs would be more than 50 times the TSP’s current 2.9 million participants, there would be a potential need for more than 10,000 highly trained telephone counselors.

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counselors to maintain the same level of service as provided by the TSP. (In addition, SSIAIs, unlike the TSP, would require a large number of counselors who speak foreign languages.) It is not likely that a federal agency could meet this need. Unlike Internal Revenue Service (IRS) and SSA counselors, SSIA counselors would be relied upon for current market, investment, and transactional information that would affect investment decisions. The well-publicized error rates of IRS counselors responding to tax inquiries in recent years would be unacceptable, especially since the SSIA administering agency might well be liable for investment losses attributable to agency error.

Electronic 401(k)s

The Internet is often suggested as a way to lower the costs of administering SSIAIs. Indeed, several 401(k) providers, including CitiStreet, now offer all-electronic services to small businesses, but costs remain high. According to its website, for all-electronic services, CitiStreet charges $2,800 a year to a company with ten employees, plus initial set-up, loan fees, and undisclosed “standard management fees charged by individual mutual funds, which are automatically deducted from participants’ returns.” Effective employer/employee costs are therefore likely to be more than $3,000. These charges are competitive with those of the high-tech services of the largest 401(k) provider, Fidelity Investments. Fidelity’s website indicates that it charges $2,950 a year for a company with 10 employees, plus various one-time charges and investment management fees. According to one 401(k) expert, Dan Esch, managing director of Defined Contribution Advisors, “The industry is now reassessing the profit potential of what seemed an exciting new way to reach untapped markets, such as small businesses . . . . There’s much more sizzle than steak.”

Dan Esch also notes that a major drawback of operating entirely online is that “you just can’t get a human being to help.” This is a critical point. CitiStreet appears to offer help in the form of e-mail answers to e-mail questions from plan participants, but this is a poor substitute for a face-to-face, or at least telephone, discussion of a participant’s problem.

Progressive Fees

The TSP has a progressive fee system. It does not charge participants fees for each service. Nor does it charge a flat dollar amount per account. Instead, the TSP calculates an expense ratio for each fund and charges the same ratio to all participants in that fund. The TSP expense ratio varies slightly by fund, but the current average expense ratio is about 0.06 percent, or 6 basis points. (As noted above, SSIA average expenses would be more than 60 percent of average contributions, so the SSIA expense ratio would be more than 6,000 basis points.) An individual with a TSP account balance of $1,000 would be charged 60 cents a year. The annual

fee would be $24 on an account balance of $40,000, $60 on a balance of $100,000, and $300 on a balance of $500,000, even though the actual cost of account maintenance is about the same regardless of the size of the account. So the holders of the higher account balances are absorbing part of the costs of maintaining the smaller accounts.

Would such a proportional fee system make SSIAIs feasible? No. There would be too many small SSIA accounts and not enough large accounts to absorb the costs. That is, 2 percent of the 2002 maximum Social Security taxable annual earnings of $84,900 is just $1,698 that an individual could contribute to a SSIA. This is a small amount compared to the $11,000 (the 2002 current statutory ceiling, regardless of income) that can be contributed annually for a TSP participant with a salary of $84,900. Thus the costs would be prohibitive for the average account, because the annual contribution would be too small. This is a key point. SSIAIs do not work for the average account—and as Robert Reischauer once said, “There can be no Lake Wobegon factor here. Everyone cannot have account balances that are above average.”

Reduced Regulatory Controls

Some have argued that the costs of doing business in the 401(k) industry could be lowered by reducing federal regulations, audits, reporting requirements, or other government interventions that create market inefficiencies. Yet, as SSIAIs would be reaching out to very small businesses and very low-income employees, the need for government controls would be much greater, just to provide minimum protection for vulnerable employees and safeguards against tax evasion.

The potential for politically motivated and costly government intervention in the stock market would also be a major concern. This concern has often been expressed in criticizing proposals to invest the Social Security trust fund directly in stocks because of the potential for preferential treatment or government control of private corporations. Even if the government were permitted to invest only in broad index funds, in order to prohibit it from investing in individual stocks, there is a perceived danger that politics might influence the selection of fund managers or the design of index funds. For example, a fund could be designed to exclude tobacco or environmentally unfriendly companies or companies thought not to be supportive of minorities, fair labor practices, low-income housing, or other social purposes.

Yet there is a failure to recognize the significant potential for political influence in the case of SSIAIs. If SSIAIs were administered by a federal agency, perhaps like the Federal Retirement Thrift Investment Board, that agency would be subject to political pressures in selecting stock index funds and fund managers. Also, because of the likely demand for a wide range of individual investment choices, there probably would be many more SSIA funds and contracts awarded for investment management than there would be if the private investments were made by the Social Security trust fund.

Moreover, SSIsAs for 155 million employees would have great potential for congressional interference in response to participant complaints about program requirements and inadequate or erroneous service from employers, record keepers, financial institutions, or other contractors. Although there would be no regulatory costs associated with Social Security trust fund investments in private securities, SSIsAs would likely involve substantial regulatory costs.

Would Congress write legislation that would effectively insulate federal agencies from political pressures in the management of SSIsAs? Congress did just that when it wrote the TSP legislation, the Federal Employees’ Retirement System Act of 1986. The Federal Retirement Thrift Investment Board has extraordinary statutory protections from political interference. It appears to be the most insulated agency in the executive branch of the government. All six named fiduciaries in the statute (the five board members and the executive director) are required to act solely in the interests of TSP participants and beneficiaries. The board’s budget is not subject to the appropriations process or to approval by the Office of Management and Budget (OMB), and its regulations are not subject to approval by OMB. Although the President appoints the board members, with the advice and consent of the Senate, there is no provision for their removal.

The executive director is even further insulated, because this position is appointed directly by the part-time board members and it is not subject to any political screening process. The executive director is in the unique position of serving as the chief executive officer of a federal agency for an unlimited term, without presidential or congressional approval. Further, the executive director has direct statutory powers, including the selection of specific investments and annuities, and the authority to select fund managers and other contractors without the prior approval of the board members.

Such extraordinary independence is warranted in the case of TSP because federal employees would not voluntarily commit their savings to a long-term retirement plan if they feared that their savings would be endangered by federal budgetary or other political priorities routinely imposed on government agencies. It is an open question whether Congress would grant such independence to the administrator of SSIsAs—this would entail giving considerable power over the tax-favored retirement savings of 155 million people in a Social Security program that is already heavily politicized.

Reduced Services

Costs could be reduced, of course, by reducing services, as some SSIA proponents have suggested, rather than modeling SSIsAs precisely on TSP or 401(k)s. Proposals have included prohibiting small accounts, loans, and emergency withdrawals, and limiting investment choices or interfund transfers to just one transaction a year. Others have suggested reducing administrative costs by providing participant statements only once a year and by delaying answering telephone calls to discourage costly inquiries—apparently a common commercial practice. Such proposals would probably not clear congressional committee scrutiny, especially in light of the well-known high standards of the TSP and 401(k)s throughout the country. The TSP service office is instructed to answer telephone calls promptly. When the Clinton
administration was reviewing SSIA proposals, then-Secretary of the Treasury Lawrence Summers reportedly said, metaphorically, that the administration had to guard against setting up the Post Office when people were used to Federal Express.  

Actually, as long as SSIA's depend upon employer performance and outreach to every workplace, the essential elements of 401(k)s, even the proposed stripped-down versions, would not be feasible. Prohibiting participation by employees with incomes of less than, for example, $50,000 (almost twice today’s average income), or raising the percentage contribution from two percent to four percent (one of the CSSS options), would not be enough. Two percent of $50,000, or four percent of about $26,000, is just about $1,000 in annual contributions, of which more than $300 per capita would be needed for administrative expenses in a plan with less than 10 employees. Thus, an investment return of more than 40 percent would be necessary just to get the fund back to $1,000 at the end of the year, generating a net return of zero. Prohibiting loans would not have much impact. The TSP does not charge loan fees, and major 401(k) providers charge only about $50.  

Limiting investment choices would help, because it would reduce the education, record keeping, and error correction costs of employers and 401(k) providers—but there probably would not be a meaningful reduction in charges by investment managers. That is, the aggregate amount of proposed SSIA investments would be so large that the competition among private investment managers would keep their charges down, with or without a choice of funds. Investment managers already have minimal expenses because they have no need to know anything about individual participants. Transactions would be consolidated by the record keeper in low-cost electronic communications among financial professionals.

TSP SERVICES AND THE PROSPECTS FOR IMPLEMENTATION IN SSIA'S

The TSP, like large private 401(k) plans, provides extensive educational, counseling, record keeping, investment, loan, and withdrawal services. The TSP relies heavily on government agencies to provide these services through their Human Resource Departments free of charge.

Educational and Counseling Services

TSP educational services include periodic distribution of lengthy plan summary booklets to all eligible federal employees. These booklets describe every significant element of TSP benefits, investment choices, recent fund performance, tax treatment, withdrawal options, and plan administration. TSP makes bulk shipments to employing agencies for distribution to their


employees. SSIs would presumably rely on SSA’s mailing list of 155 million taxpayers; based on SSA’s experience with that mailing list, SSA estimates that 25 percent would be returned as undeliverable.28

Other TSP materials, including promotional posters in every workplace; leaflets; animated videos; extensive investment, loan, and annuity booklets; and other educational materials have also been essential to help every eligible federal employee understand the benefits that Congress intended them to have. It would be extremely costly to try to replicate this communications system in every tiny SSIA workplace.

The Federal Retirement Thrift Investment Board staff also provides extensive “train-the-trainers” sessions in Washington, DC and throughout the country for agency personnel and payroll officers, who in turn deal directly with TSP participants throughout the world. The TSP statute requires the Office of Personnel Management to provide for training retirement counselors in every federal agency, and the board assists in that effort. This obviously could not be done at more than six million places of business.

The entire TSP educational and communications program is dependent upon implementation by the existing staffs of federal employing agencies, not by the staff of the TSP board. Although the initial coordination of the agencies was a great challenge, the administrative structure—the personnel, payroll, and computer systems offices—was already in place when the TSP was established. Thus the TSP is essentially a wholesaler of services. The employing agencies are the retailers and benefit providers, and they furnish the face-to-face counseling and support critical to the success of the TSP. Without such enlightened employer support, which could never be provided effectively by outside contractors, SSIs could not succeed.

In establishing 401(k)s for large and medium-size businesses, there is also a significant administrative structure upon which to build. But for SSIs there is no existing structure for the more than six million small businesses, and they are generally incapable of performing the functions or assuming the fiduciary responsibilities normally expected of 401(k) employers. It would obviously be impossible to model SSIs on the TSP or 401(k) educational and counseling structures.

Some persons who would be eligible for SSIs could be minors or others incapable of making investment decisions or who have very limited language skills and have never filed tax returns, maintained checking accounts, or invested in anything. Yet effective communication with these people would be essential to carry out a congressional mandate that all Social Security taxpayers be fully informed of this new entitlement.

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**Investment Functions**

Similarly, SSIA employers, unlike the employing agencies under the TSP, could not be expected to assume responsibility for the timely processing of investment decisions and guarantee employees against investment losses caused by employer error in implementing initial investment decisions. Additional stages where problems could occur include changes in payroll deductions, interfund transfers, and other transactions affecting the timing and amounts of daily market investments. Such burdens would be unacceptable to small businesses that are not now exposed to market risks and that are now required to submit information on individual employees to the Social Security Administration only once a year. Moreover, 650,000 employers go out of business or start new businesses each year—a 10 percent turnover rate. Also, 85 percent of employer transactions with SSA are still on paper.²⁹

All of these 401(k)-type employer functions would be daunting for typical small businesses such as the neighborhood garage, beauty salon, barbershop, or restaurant where both employers and employees have little or no experience in the world of finance or 401(k)s. Also, such functions would be a significant burden for many of the self employed, who make up 9.7 percent of all Social Security taxpayers in the United States,³⁰ and for household employers who engage domestic workers, such as house cleaners and nannies. It is not that these workers cannot be encouraged to save, it is just that it is irresponsible to suggest that the model for such savings could be the TSP.

**Record Keeping Services**

There is a tendency in this high tech age to dismiss the challenges of developing large integrated accounting and record keeping systems. Yet one need only look at the well-publicized failures to design and install such computer systems in recent years at the General Services Administration, the Agency for International Development, the Office of Personnel Management, the Internal Revenue Service, and other federal agencies. In fact, the TSP board recently fired and sued American Management Systems for failure to deliver a new record keeping system after several years of trying.³¹ None of these failures, each involving tens of millions of dollars, could begin to compare with the scope and complexity of the federal administration that would be required for the day-to-day investment, loan, withdrawal, and other program actions of 155 million Social Security taxpayers. SSIA record keeping would require a financial computer system utterly without precedent anywhere in the world.


A universal SSIA system would have to reach not just the 6.5 million employers but also the 14 million self-employed individuals (with an average income of just $13,220),\(^{32}\) who are generally not included in 401(k) plans and are unlikely to deal with a record keeper the way TSP or 401(k) employing agencies now do. Much of the target market for SSIA is unexplored territory—it certainly is not 401(k) territory.

Although the IRS and SSA are accustomed to dealing with nearly the entire labor force, their programs are relatively passive compared to the interactive dynamics of time-sensitive investment management. Even with the support of a sophisticated employer network, it would be a daunting task to model SSIA on the TSP, where the standard is biweekly collections and daily reconciliation of financial transactions to the penny. Without that network, it is clearly impossible. It takes SSA up to 22 months after tax payments to attribute 98.5 percent of payments to individual taxpayers; and the other 1.5 percent are never reconciled.\(^ {33}\)

An important feature of the TSP record keeping system is error correction. Errors inevitably occur because of untimely actions by employees, employing agencies, or the record keeper in the investment of funds, interfund transfers, loan repayments, and other transactions affecting fund earnings. It is then necessary to fix responsibility for the error and for the cost of correcting it. Precise calculations are made on what earnings in each TSP fund would have been were it not for the error, and such calculations may be for long periods of changing market conditions during which the error was undetected. (In contrast, SSA usually does not even pursue employers who fail to pay Social Security taxes when the amount due is less than one wage credit [$870 in 2002], since such underpayments generally will not affect an individual’s Social Security benefits).\(^ {34}\) The costs of detecting, investigating, and correcting each error when dealing with so many millions of individual participants, all with differing levels of financial sophistication, would be incalculable. Just correcting errors could bring the program to a halt.

The Social Security Administration estimates that it would need 34,000 new employees to administer SSIA, not including employees of other involved public or private agencies, or additional SSA employees for several program items SSA did not cost out.\(^ {35}\) Fidelity Investments, an industry leader, estimates that the total staff needed would be 100,000 persons.\(^ {36}\)


Loans and Emergency Withdrawals

The TSP, like 401(k)s, permits participants to borrow or make emergency withdrawals from their accounts. It would be difficult to get 401(k) employees to make substantial voluntary contributions to their retirement accounts if they thought that they would never have access to the money in an emergency. Without emergency withdrawal provisions for such purposes as financial hardship, health, education, and housing, SSIs would be a relatively unattractive product compared to 401(k)s and even IRAs. If emergency withdrawals were authorized, then loans would also be appropriate, since they provide the opportunity for participants to repay and thus restore their retirement savings accounts. Because a purpose of SSIs is to augment Social Security, Congress would presumably require strict enforcement of documented support in applications for emergency withdrawals.

The most common SSIA proposal is to permit two percentage points of the present 6.2 percent employee Social Security tax to be invested in SSIA accounts, the so-called “carve-out” option. Thus, if people were able to withdraw their money early they could in effect evade that two percent portion of the tax. There is no basis in 401(k) or IRA experience for estimating the cost of the required enforcement, or the cost of related enforcement actions against employers, third-party administrators, or investment managers with fiduciary responsibilities for SSIs.

Even with the so-called “add-on” approach, in which there would be no reduction in Social Security taxes deposited in the trust fund, there would be a need for enforcement to prevent abuses such as timing short-term deposits or withdrawals to manipulate taxable income from year-to-year. This would undermine the purpose of augmenting Social Security. The “add-on” approach is advocated by those who want to preserve the existing Social Security system.

Some have suggested that loans and emergency withdrawals should not be permitted. But since SSIs would be vested in individual names, unlike the Social Security trust fund, it may be unrealistic to try to ban early withdrawals. For example, when enough distressed spouses of disabled, deceased, or unemployed workers beseech their members of Congress to let them withdraw funds from their own vested accounts to feed their children, repeal of the ban would be the popular political (and humane) thing to do. The TSP was initially authorized to make loans but not emergency withdrawals, but Congress eventually amended the statute to permit such withdrawals.

Retirement Withdrawals

At the time of retirement from federal service, TSP participants may elect to withdraw their funds in the form of a lump sum, equal payments over a fixed period, or through an annuity purchased for them (from Metropolitan Life Insurance Company at this time) by the TSP. (There are many different types of TSP annuities, depending upon choices of various combinations of benefits for spouses or other beneficiaries, guaranteed minimum payments, and indexation.) This is another point at which some SSIA proponents depart from the TSP model; they would
permit annuities only, in keeping with the fundamental Social Security principle of guaranteeing a lifetime income.

**SUMMARY AND CONCLUSION**

Universal SSIAAs could not be successfully modeled on the TSP or private 401(k) plans. Nor could they achieve the President’s stated goal of augmenting retirement savings, compared to Social Security trust fund investments. There would be too many low-income employees and too many very small businesses for SSIAAs to be cost effective. More than 85 percent of businesses with fewer than 100 employees have no retirement plans. Small businesses generally do not have the financial resources or the personnel, payroll, or computer systems staffs to do what employers who sponsor 401(k) plans now do. They could not be expected to assume the expenses or fiduciary responsibilities of 401(k) employers.

An annual SSIA contribution of 2 percent of the average annual salary of about $26,000 would be so small (about $520) that more than half of the contribution would be required just to cover administrative expenses. Per capita administrative expenses would average more than $300 a year (and much more for employees of very small companies based on current market costs, because the average employer would have too few workers to absorb the fixed costs of administering a plan at each workplace). If the administrative expenses were absorbed by government or employers, that potential cost of more than $46 billion a year (155 million full- and part-time workers times more than $300 per account) would be a subsidy to the 401(k) industry for performing an uneconomic function. If the goal is to subsidize small savers, there are many other ways to do much more with much less money. The entire $46 billion expense could be avoided simply by investing the Social Security trust fund.

The prospects for future cost reductions are not good. The major 401(k) providers have been searching over many years for ways to supply 401(k) plans to small businesses. They have achieved substantial economies of scale with state-of-the-art technology, but they still charge more than $3,000 a year for the average small business, which has fewer than 10 employees. Thus major providers recommend against 401(k)s for businesses with fewer than 10 workers, and some advise against them for firms with fewer than 20 or 25 employees. The only way to bring costs down to acceptable levels would be for small businesses to merge into firms large enough to have the resources to support 401(k) plans, and that obviously will not happen.

There is no reason to assume that a federal agency, even with the estimated 100,000 new employees needed to do the job, could do what the largest private financial institutions have been unable to do in a cost effective way. Moreover, the error rates that are now tolerated by the IRS and SSA would be totally unacceptable in a 401(k) environment of day-to-day investment transactions.

Modeling a part of Social Security after the TSP or 401(k)s simply does not work; they are two entirely different concepts. Social Security is mandatory—it is a tax; 401(k)s are voluntary, for both the employer and the employee. Social Security is an insurance program;
401(k)s are investment programs. Social Security depends on government to absorb inflation and market risks; 401(k)s shift those risks to individual investors. Social Security is a defined benefit program; 401(k)s are defined contribution programs. Social Security is a safety net for lower-income people; 401(k)s are a major tax subsidy for higher-income people. Social Security is sponsored and administered by the government; 401(k)s are sponsored and administered by employers. Attempts to combine these two fundamentally different programs are like mating a bear with a bee—somebody is going to get hurt.